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TAXES: SUPPLY-SIDE THEORY REVISITED

HEARING

BEFORE THE

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CONGRESS OF THE UNITED STATES

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TAXES: SUPPLY-SIDE THEORY REVISITED

TUESDAY, SEPTEMBER 17, 1985

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representative Obey.

Also present: Scott Lilly, executive director; and Paul Manchester and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Good morning.

In his first major address to the Congress in February 1981, President Reagan said that his tax plan would lead to 13 million new jobs by 1986, with economic growth averaging 4 to 5 percent a year. This growth was to be achieved by the enhancement of incentives on the supply side of the economy, and it was contrasted with the demand-led booms of the 1970's.

The Congress passed legislation which reduced the top marginal tax rate from 70 to 50 percent to encourage work, savings, and investment. These tax cuts helped higher income people more than middle and lower income families, but we were told not to worry about fairness or budget deficits, because we were told that the supply-side effects would create the kind of economic growth which would help us grow out of those deficits.

That didn't happen. We certainly haven't grown out of the Federal budget deficit. In fact, we have added another deficit—the trade deficit. Last night the television news reported that second quarter results indicate that we have now passed into international debtor status for the first time in over 70 years.

Now we are being told again that we ought to lower the top marginal rate further, to 35 percent, to stimulate investment which will help us grow out of the budget deficits.

It is useful to examine what happened the last time those claims were made in determining whether, at a time when budget deficits are going through the roof, we should put as our first priority further reductions in tax rates rather than deficit reduction.

We have with us this morning two distinguished panelists: Mr. Barry Bosworth of the Brookings Institution and Mrs. Isabel Sawhill of the Urban Institute.

Mr. Bosworth, why don't we begin with your statement.

STATEMENT OF BARRY BOSWORTH, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. BOSWORTH. Thank you. I had a prepared statement that I provided to the committee earlier so I think to save time I'll just try to summarize a few remarks and points that I want to make in that.

Second, in evaluating this program I would like to stick to the subject of these hearings which is the effects that it had on the supply side of the economy and not address the impact of the tax program on aggregate demand in the economy, which I think was very important and played a critical role in getting the United States out of the recession we were in in 1980 to 1982.

But I think when you look at the behavior of private savings and investment in particular, and I would like to focus on that rather than turning mainly to labor supply, that it is pretty clear that while we debated at length back in 1980 what would happen in the future because we had very little experience on which to judge the performance of a program like this, we are now looking back after 5 years and I think it is time to conclude that in terms of its primary goal of stimulating private capital formation in the United States this program has been a failure.

I think the table that I handed out with the prepared statement that just looks at savings and investment rates in the United States clarifies that point.

First of all, the private savings rate in the United States is very low compared to other countries, but one of the critical points to make about it, it has been extremely constant over the whole postwar period and as far back as we have national income accounts statistics in the United States. On a net basis, the United States has consistently in the private sector saved between 8 and 9 percent of its GNP. If we look at the period since 1981, in fact the private savings rate in the United States has tended to remain in exactly the same range.

It's clear that private people spent their tax cut about the same way they would spend any other income increase, be it wages or dividends or interest. They spent about 90 percent of it. The private savings rate has remained in the range of 8 to 9 percent. In fact, for the first half of 1985, the net private savings rate in the United States has declined slightly to 8.5 percent of our national income.

But at the same time, we've had a tremendous decline in the national savings rate, not because of changes in behavior in the private sector but because the Federal Government which used to dissave a small amount of the national income usually taking up about 1 to 2 percent of the GNP to try to finance its average deficits in prior decades, has seen its dissavings explode to the point now that the Federal budget deficit is running in excess of 5 percent of the Nation's income.

That means that just to finance the Government deficit takes almost two-thirds of all private savings in the United States.

A few years ago most economists looking at those projections expected the outcome of this, a tremendous decline in national savings rate, yet on the other side reasonably good investment oppor-

tunities here in the United States. We projected that there would be a tremendous shortage of capital here in the United States and that interest rates would have to rise to extremely high levels in order to ration investment down to the level that we could afford to pay with our savings. That forecast turned out to be wrong and that forecast turned out to be wrong for a very dramatic reason, which is we never anticipated the ease with which this country could borrow overseas.

And now we are, incredibly, borrowing over 3 percent every year of our national income overseas in an effort to try to finance investments that we don't have the national savings or domestic savings to finance ourselves.

The result of that has been that this Nation has been able to maintain a domestic rate of investment just about exactly the same as the historical experience of the 1950's, 1960's, and 1970's.

However, the important point to make is that that investment is not being undertaken by Americans. It's being undertaken by foreigners. As a nation, we in fact have the lowest rate of saving and investment that we've had any time since the Government recorded national income statistics. We are presently saving and investing only 3 percent of our income.

As the papers made clear this morning in reporting on our trade position, in essence this economy is in the midst of an enormous consumption boom and we are financing that consumption by a rapid running down of our assets, both foreign and overseas. To find that the richest country in the world has now become a net debtor nation does seem to many, I think, somewhat obscene.

But to turn to some of the details of this, I think the most striking part of the economic development since 1981 has been the failure of the private savings rate in the United States to increase. That's particularly dramatic if you look to see what's happened to potential rates of return on private savings.

We could hardly ask for a more dramatic laboratory experiment to see what would happen if we offered people a higher rate of return on their savings. Rates of return have gone up both because we lowered marginal tax rates and because they reached much higher, nearly double, the real rate of interest that they received during the 1970's in financial markets, and third, we deregulated much of the financial markets in order to make those higher rates of return available to a much wider range of savers.

Furthermore, the Congress, in addition, enacted an extremely large incentive to increase savings for retirement purposes with the expansion of the IRA accounts.

Yet when all those things took place and we have now had 5 years to see whether or not private sector behavior would change in response to it, we find the private savings rate is in exactly the same range that it was.

I think one of the prime examples of the difficulties of trying to use tax provisions to encourage private saving is noted just by looking at the Government's data on IRA accounts. They rose from about $4.7 billion going into IRA accounts in 1981 to $32 billion in 1983. That's a change equal to almost a full 1 percent of the national income. That's a magnitude of change that should be very visible

in total savings if in fact it represented savings. Yet the private savings rate declined in 1983 after adjustment for cyclical effects.

I believe instead that the tax measures simply led individuals to do what I do, which is to liquidate your taxable savings accounts, take the money and put it in an IRA. We are reallocating our savings in response to the tax advantages, but we are not increasing our savings.

In fact, we are now faced with bank advertisements encouraging individuals to borrow money and take it as a tax deduction on their tax return in order to invest it in a nontaxable IRA. That is an obvious gross perversion of the original concept of this program.

I think the final aspect of the savings behavior also relates to the argument that's become increasingly popular recently, to say that we shouldn't worry about the budget deficit because all of us are aware of the increasing burden that it will place on our heirs and therefore we will automatically adjust our private savings rate to offset the burden of dissaving by Government. Clearly, that has not happened. The sharp magnitude of increase in the Government deficit has translated into a dramatic decline in the national savings rate.

I think if we were truly concerned about national saving and capital formation in the United States, we would focus on the national savings rate, not just the private savings rate. Increases in private savings, even if they had occurred, if they must be diverted to financing larger public sector deficits serve absolutely no national purpose. From that perspective, a reduction in budget deficit would be the most effective means of raising the national rate of capital formation.

Second, the surge in investment spending since 1981 would seem to provide the strongest evidence of the positive influence of the economic recovery program, and certainly there is far more agreement among economists that taxes can have a major impact on investment than for savings decisions. However, again, there's a major disagreement with the magnitude of the effect projected by the administration when they said national rates of savings and investment would increase by nearly 50 percent.

In a recent study I attempted to examine the composition of the investment spending in recent years, expecting to find that those types of assets that had had the biggest tax reductions would be the assets on which spending would rise the most. Instead, I found that 93 percent of all the rise in equipment spending since 1979 is accounted for by two assets—office equipment, meaning basically personal computers; and business purchases of automobiles.

If you look at what happened under the 1981 Tax Act, we actually increased the tax rate on computers and we did not change the tax treatment of business automobiles. Furthermore, those categories of business investment that benefited the most from the new Tax Code were the ones that grew the least; namely, industrial capital formation.

Many of the potential benefits of the Tax Act were simply offset by increases in the cost of borrowing funds. Instead, I think that much of the recovery in business investment would relate to a technological innovation having nothing to do with taxes or other

economic developments; namely, the invention of the personal computer and the spread of it to office use.

Furthermore, if we look at what's been happening in business automobile investment, why is that rising so sharply? Well, what used to happen is people bought an automobile for their own use and it was recorded in the national income accounts as personal consumption expenditures. Now more and more people are deciding to lease their automobile from a rental car firm. That rental firm reports the purchase of the automobile as business investment. It's simply a reclassification from personal consumption to business investment and does not represent a true increase in investment.

Investment in industrial capital which might be expected to improve the competitive position of American industry has been in fact declining steadily as a share of our national output.

Finally, I think the budget policies adopted in 1980 have had a severe impact on the ability of American industry to compete in the world economy. While we complain about foreign competition, we forget that the United States needs to borrow abroad today. We are a nation critically short of savings since we use all of our income to finance our own consumption, both private and public. Yet compared to other countries, we do have reasonably good investment opportunities.

The result has been an increase in foreign demand for dollars to finance investments that we are unwilling to finance ourselves. The resulting rise in the exchange rate, falling import prices, and increase in the cost of American goods in world markets is simply the process by which those goods and services are moved here to the United States.

The trade deficit is a direct reflection of the decline in national savings.

I also provided the committee with a chart to try to illustrate the decline in the competitive position that American industry has experienced in recent years.

If we compare the cost of producing goods and services here in the United States with 14 major trading partners, you find that the relative cost of production in the United States has increased by over 40 percent since 1980. Meanwhile, Japan has had a decline of nearly 40 percent in its production costs and if you look at the indexes for other countries such as Germany, Great Britain, and France, they have also trended down.

The problem with trade for the United States in world markets is simply not trade restrictions by other countries. The truth of the matter is, our goods cost too much. If other countries such as Japan should in fact liberalize their restrictions that they have on imports, it is not the United States that would benefit. It is other industrial countries that would again find that they could outcompete us in terms of the prices that they would offer Japanese consumers.

The basic problem with American trade in world markets is that we can't compete at the levels of exchange rate we now have and, in turn, the exchange rate has been driven up by our need to attract foreign capital to finance investment projects here in the

United States that we are unwilling to provide savings for to do ourselves.

I think these points have some applications to the current discussion over taxes. First of all, if we were truly interested in increasing, as I mentioned, the national savings rate, we would focus on reducing the size of the budget deficit, not attempt another round of special tax provisions justified by the persumed impact on private savings incentives.

Because these savings incentives have such a low bang for the buck they actually reduce national savings. The rise in private savings is much less than the increase in the Government deficit that they cause.

Second, in the effort to promote capital formation, there's been far too much emphasis on taxes and too little emphasis on other factors such as the cost of borrowing funds. In recent years, the presumed benefits of tax incentives have been swamped by rising real interest rates, the loss of competitiveness of American industry, and the uncertainty that surrounds future economic trends.

I think these problems are becoming increasingly evident in the latest survey of business investment anticipations which was extremely weak for future years. More and more business firms are beginning to realize that while the American economy is an excellent place in which to sell, it is a very poor place in which to produce. And more and more firms are beginning to say if they need to expand they are going to expand overseas.

One of the most dramatic measures of this is that the United States prides itself on how advanced it is in the area of computers. We are now a net importer of computer equipment in the United States.

Even in these high technology areas, we find ourselves unable to meet foreign competition.

I think if the Government wanted to do something about these problems, it would be far better advised to get its own house in order. In fact, you may remember a few years ago when less-developed countries were experiencing severe problems with their own abilities to handle debt financing, our Government told them that they ought to learn to live within their means. That's a little hard for less-developed countries to learn to do, but they have made remarkable progress.

But today we find a situation where the United States is borrowing more money in world capital markets than all the less-developed countries taken as a whole. The only benefit of this program is at least we don't have any lectures from our Government officials about how people should learn to live within their means. But in fact, I think the United States could use a little bit of its own advice.

Thank you.

[Mr. Bosworth's prepared statement follows:]

Prepared Statement of Barry Bosworth

The 1981 Economic Recovery Program was originally promoted as a major effort to stimulate growth on the supply side of the U.S. economy. Reductions in marginal tax rates were designed to expand incentives to work, save, and invest. The potential economic effects of that program generated substantial controversy among economists and others. The Administration, led by supply-side economists, argued that the program would create 12 million new jobs between 1981 and 1986, 3 million more than if nothing was done; raise the growth of real output from an annual average of 3.1 percent in the 1970s to 4.4 percent in 1981 to 1986; and increase the share of national income devoted to saving and investment by more than 50 percent. Finally, improved productivity growth would enhance the competitive position of U.S. industry in world markets.

Economists outside the Administration were more inclined to interpret the tax reduction as a traditional Keynesian program of demand stimulus, albeit under the disguise of a new label. As such, they disagreed with the projected magnitude of the program's impact on the supply side of the economy, particularly the assumption that the personal income tax cut would translate into a major rise in private saving rates. There was room for disagreement, however, because there was no prior history of such major changes in marginal tax rates, and we have lacked the type of laboratory experiments that would provide conclusive evidence on either side of the debate.

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The passage of time, however, does allow us to evaluate the program on the basis of actual developments, rather than relying on differing conjectures about future events. Of course, other factors have also not been as expected; but, the hypothesized effects were so large that it is unlikely they could be swamped by offsets in other areas. The issue is also of considerable current interest because the Congress is in the midst of another restructuring of the tax system.

My own conclusion on the basis of developments to date is that the Economic Recovery Act has expanded the demand side of the U.S. economy--providing a powerful stimulus to lift the economy of the recession of 1980-82, which was induced in turn by the efforts of the monetary authorities to bring inflation under control. As a stimulus to supply, however, the program has been a failure, actually resulting in a pattern of national saving and investment that has reduced the long-term growth rate of the U.S. economy. Contrary to the original goals, the United States is on a consumption binge, financed by the liquidation of its assets abroad and the lowest rate of national saving and investment since the 1930s.

I would like to focus my remarks on the effects of the program on saving and investment, but let me make a few remarks about some other issues. First, the economy has fallen far short of the Administration's target for output growth--averaging less than 3 percent since 1981 and the consensus for the future is no higher. Second, on the basis of the Administration's own forecast, there have

been no gains in employment and labor supply. Even with an optimistic forecast for 1986, employment growth will only achieve the base-line level projected by the Administration to exist in the absence of the program. Labor-force growth is equal to, or below, prior projections and, of course, the unemployment rate remains far above both the Administration's projections and normal historical performance.

It is too early to form any firm judgments about the post-1981 trend in productivity growth because of the extreme importance of cyclical influences. I have seen some economic studies asserting that the underlying trend growth rate has improved, and others asserting that it has not. In any case, the means proposed to raise productivity, namely higher saving and investment, can be expected to work only with a long lag. Thus, I believe, it is more reasonable to look at the intermediate goals of increasing rates of saving and investment.

The major points that I wish to make about capital formation in the United States are summarized by the data in Table 1. I have provided a historical summary of the identity that must hold for any economy by which private saving (households and business) plus government saving (the budget deficit) define the amount of resources available for domestic plus net foreign investment. All of the data are expressed as percentages of net output. The data supports the following points:

o First, there has been no major change, either up or down, in the

private saving rate. It continues to adhere to the long-run historical trend of a net saving rate of about 8-9 percent. In effect, individuals treated the tax reduction of 1981-83 much like any other income gain, spending about 90 percent.

- Second, on the other hand, there has been a tremendous decline in the national saving rate because of a large increase in the government budget deficit. The national savings rate has declined from a historical range of 7-8 percent down to 4.4 percent in 1984. Half of all private saving must be used simply to finance the budget deficit.
- Despite the decline in national saving, the rate of net investment in the domestic economy have remained near the historical average of about 7 percent of national output. But, that has been possible only by large amounts of borrowing overseas.
- Net foreign investment, which has been historically a small positive use of U.S. saving, is now a negative 3 percent of income. In effect, it is foreigners, not Americans, who are doing the investing in the U.S. economy, and it is they, not Americans, who will receive most of the benefits--interest and dividend payments in future years.
- Net investment by Americans, both domestic and overseas, is at its lowest rate since the 1930s.
- Sometime this year the United States should become a net debter nation, owing more to foreign nationals than they owe to us. In

just a few years, we have managed to liquidate a stock of foreign assets built up over earlier generations. At present rates, the United States can be expected to borrow about $1 trillion overseas during the 1980s in order to support domestic spending in excess of our own production.

Several years ago, the standard forecast among economists (including myself), was that the sharp rise in the budget deficit (decline in saving) would, in the face of good domestic investment opportunities, initiate a heightened competition for credit in the United States, as higher interest rates would be required to push down domestic investment in line with the reduced supply of saving.

That forecast was wrong. It was wrong because we failed to anticipate the ease which which the United States could borrow overseas. That foreign borrowing has played a key role in providing the financing for investment that we have been unwilling to provide for ourselves.

The major uncertainty about the future is how long that process can be sustained. On that issue, I feel no economist is comfortable in making an explicit forecast. This is a situation with which we have little historical performance, and it is very difficult to anticipate how long foreigners will be willing to continue this lending. From their perspective, rates of return are higher in the United States than in other areas of the world economy; and, while the United States is now borrowing more than all the developing countries taken as a whole,

current debt levels are still quite low.

In essence, the United STates is in the midst of a consumption binge, financed by foreign lending and a liquidation of the assets accumulated by prior generations. As with a family, we know that a day of reckoning will come, when we must repay those debts. But, unlike a family, that day may not come during the life of the current generation.

You may remember, however, that a few years ago, in the midst of a debt crisis in the developing countries, our government officials counseled them to live within their means. That is hard for low-income countries to do, but they have made remarkable progress. We could now use a little of our own advice.

The failure of the private saving rate to rise after 1981 is the most striking departure from the program's promises. Certainly there has been a major increase in the after-tax return to savers. We could hardly ask for a more dramatic test. The rate of return rose because of: (1) lower marginal tax rates, (2) higher real interest rates in financial markets, and (3) financial deregulation to make those rates available to a much larger number of savers. Furthermore, a large direct incentive for retirement saving was provided by the liberalization of investment retirement accounts. Yet, the private saving rate continues at its historical level.

A prime example of the difficulty of relating the tax provisions to the overall saving rate is provided by noting that the annual inflow of funds to IRA accounts rose from $4.7 million in 1981 to $32.3 billion in 1983--a change equal to 0.9 percent of net national product. Yet the overall private saving rate declined even after adjustment for cyclical effects. I believe that the tax measures simply led individuals to switch the composition of their wealth, moving from taxable savings accounts to IRAs, rather than foregoing consumption. In fact, we are now faced with bank advertisements urging individuals to borrow funds to invest in IRAs--a gross perversion of the original concept.

A further aspect of the data in Table 1 relates to the argument made by some that we should not worry about the budget deficit because private individuals will adjust their own saving to offset any burden of that debt on their heirs. Clearly, that has not happened. The sharp magnitude in the increase of the government deficit has translated into a decline in total national saving. Historically, there is some evidence of an inverse relationship between government deficits and private savings; but, at most, changes in private saving can be expected to offset no more than one-fourth to one-third of a change in the budget deficit.

If we were truly concerned with saving and its implications for capital formation, we would focus on the national saving rate, not just private saving. Increases in private saving, if they must be diverted

to financing larger public-sector deficits, serve no national purpose. And, from that perspective, a reduction in the budget deficit would be the most effective means of raising the national rate of capital formation. In the face of the large current and perspective government borrowing, tax incentives pale in significance as a means of increasing the rate of national capital formation.

The surge in investment spending in 1983-85 would seem to provide the strongest evidence of the positive influence of the economic recovery program. And, certainly, there is far more agreement among economists that taxes can have a major impact on investment than for saving decisions. However, again, there is a major disagreement with the magnitude of the effect projected by the Administration. In a recent study for the Brookings Institution, I attempted to examine the composition of the investment spending in recent years. I found that 93 percent of the rise in equipment spending since 1979 is accounted for by two assets: office equipment (mainly computers) and business purchases of automobiles. Yet, neither of these assets experienced a reduction in tax rates after 1981. Furthermore, the categories of business investment that benefited most from the new tax code were the ones that grew the least. Many of the potential benefits of the tax act were offset by increases in the cost of borrowing funds. Much of the recovery in business investment would seem to relate to a technological innovation (computers) rather than the tax reduction. Furthermore, much of the growth in business automobile purchases simply

reflects a shift in the pattern of spending as people who used to buy automobiles and called it consumption now lease those automobiles from private firms who report the automobile purchases as investment. Investment in industrial capital, which might be expected to improve the competitive position of American industry, has been declining steadily as a share of national output.

Finally, the budget policies adopted in the 1980s have had a severe impact on the ability of American industry to compete in the world economy. While complaining about foreign competition, we forget that the United States needs to borrow abroad--import more than we export. We are a nation short of saving, since we use all our income to finance our consumption--both public and private. Yet, compared to other countries, we do have good investment opportunities. The result has been an increased foreign demand for dollars to finance investments that we are unwilling to finance for ourselves. The resulting rise in the exchange rate, fall in import prices, and rise in the cost our exports is simply the process by which goods and services are transferred to the United States. The trade deficit is a direct reflection of the decline in national saving.

The loss of competition is clearly evident in Figure 1 which shows the relative costs of production in the United States compared to its major competitors. Because of the rise in the value of the dollar, the competitive position of American manufacturing has declined by 40 percent since 1980. Meanwhile, countries such as Japan and Germany

have made major gains at our expense. The loss of competitiveness has been bad news for workers in industries that must sell in world markets; but, rather than blaming foreigners for our problems, we should realize that we did it to ourselves, with a national economic policy that emphasizes consumption at the expense of saving and investment.

The experience since 1981 does, I believe, have some implications for the current round of debate over tax reform. First, the most effective means of restoring the national saving rate would be to focus on reducing the size of the budget deficit, not another round of special tax provisions justified by their presumed impact on private saving incentives. Because these saving incentives have such a low bang-for-the-buck they actually reduce national saving--the rise in private saving is less than the increase in the government deficit that they cause.

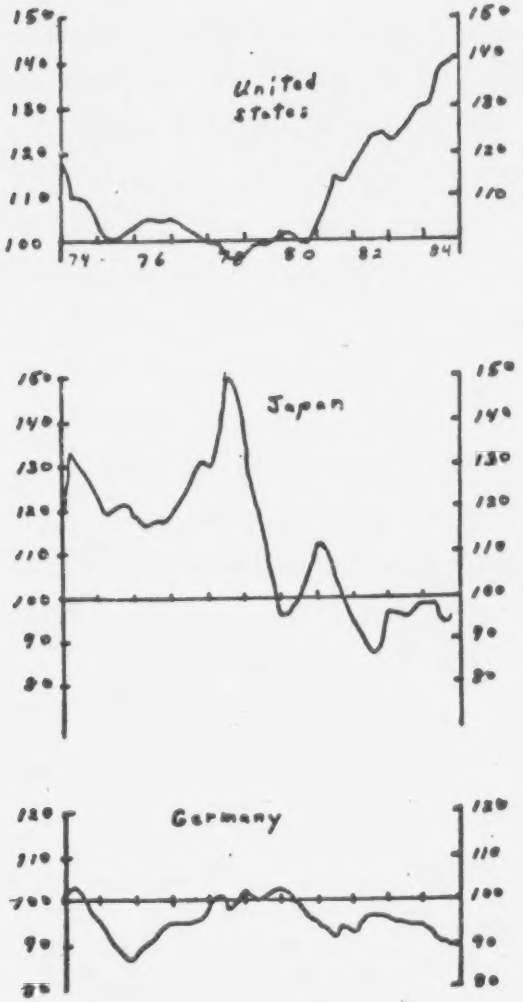
Second, in the effort to promote private capital formation, there has been too much emphasis on taxes and too little emphasis on other factors. In recent years, the presumed benefits of tax incentives has been swamped by rising real interest rates, the loss of competitiveness of American industry, and the uncertainty that surrounds future economic trends. Recent survey responses of American businesses seem to concur that the outlook for domestic investment is not good as they are beginning to move their production facilities overseas. The government would be better advised to get its own house in order.

Third, in all the discussion of the presumed benefits of lower tax rates on capital income, we have lost sight of the fact that lower taxes on one form of income must be paid for by higher taxes on others. Over the postwar period, the only increase in taxes has been in that on labor income--effective tax rates have fallen on capital income. We should be more concerned about the disincentive effect on higher-wage taxes on work effort rather than focusing so heavily on capital income taxes at the top of the income distribution.

Finally, the tax system has become so complex, with myriad special provisions for different types of saving and investment, that economists can no longer tell you whether a specific provision actually promotes or discourages capital formation. Effective tax rates are actually negative on some types of investment and prohibitive for others. Yet, there is such an enormous interaction between the tax system and the method of financing an investment project that the final outcome is very uncertain. I believe that the major emphasis should be placed on moving toward a simplier tax system, eliminating the special provisions, broadening the tax base and reducing the overall structure of rates. The Congress is now attempting to achieve so many special goals through the tax system that it has lost sight of the fundamental purpose of the tax system: to raise revenues to pay for government programs.

Figure 1. Indexes of Relative Production Costs, United States, Japan, and Germany, 1974-84

1980 = 100



Note: Indexes of unit labor costs measured in U.S. dollars and divided by an average of costs indexes for 14 other industrial countries.

Table 1. Saving and Investment as a Share of National Product, United States, 1951-85

percent

Item	Percent of Net National Product				
	1951-60	1961-70	1971-80	1984	1985 1st Half
Net Saving[a]					
Private Saving	8.4	9.2	8.9	9.4	8.5
Government Saving	-0.7	-1.0	-2.0	-5.1	-5.3
Net National Saving-Investment	7.7	8.1	6.9	4.4	3.1
Net Foreign Investment	0.3	0.6	0.0	-2.8	-3.3
Net Domestic Investment	7.4	7.6	6.9	7.2	6.4

Source: U.S. Department of Commerce

a. Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals GNP minus capital consumption allowances. Pension funds of State and Local governments are allocated to private saving.

Representative OBEY. Thank you.
Mrs. Sawhill.

STATEMENT OF ISABEL V. SAWHILL, ECONOMIST, THE URBAN INSTITUTE

Mrs. SAWHILL. Mr. Chairman, I will try to summarize my prepared statement and I would also like to say at the outset that I certainly agree with many of the points that Mr. Bosworth has made.

My first point is that the impact of tax incentives on long-term economic growth has been exaggerated by supply-side economists. The potential limits of supply-side economics are perhaps best illustrated by some estimates we made at the Urban Institute of the likely increase in real GNP growth over the long run as the result of the supply-side measures introduced in 1981–82.

We found that under a very optimistic scenario that assumed savings, investment, and labor force participation were responsive to the tax cuts at that time and also assumed rapid and substantial action on the budget deficits, that real GNP might increase by as much as one-half of 1 percentage point per year. In other words, if your projection for long-term growth was that real GNP was going to grow at any average of 3 percent per year with no change in policy, it's possible under this very optimistic scenario about the impact of supply-side economics that you might get up to 3.5 percent a year for about a decade. At the end of that period, the cumulative benefits for very person in the United States would be about $1,000 in additional income in 1984 dollars.

On the other hand, under more pessimistic assumptions that didn't assume early action on the deficits and didn't assume that the magnitude of the supply-side response would be as great as most supply-siders expected, the growth rate of real GNP could be as much as one-half of 1 percentage point lower per year, with the result that everyone might be $1,000 poorer in about 10 years from now.

This result occurs because any positive effects of reduced tax rates are assumed to be small and are more than offset by the effects of deficits on investment and long-term growth.

Since there hasn't been a substantial reduction in the deficit as yet, I would have to give greater weight to this more pessimistic scenario.

My second point is that there is little evidence of a supply-side response in the actual data on savings and investment and work effort for the period 1981 to 1984. With the exception of business savings or cash-flow and possibly business investment, I think everyone agrees that there is nothing unusual in the statistical record for 1981 to 1984 after one adjusts for the predictable influence of the business cycle. Some studies, it's true, have suggested that business-fixed investment was stronger during the recent recovery than what one would have predicted based on past experience. But, as Mr. Bosworth's research has shown, the composition of business spending has not been what one would have expected based on the changed structure of tax incentives.

I conclude, then, that the 1983–84 recovery was caused by an increase in total spending, fueled primarily by stimulative fiscal and monetary policies. It was not caused by a supply-side response.

My third point is that we should raise revenues by broadening the tax base rather than by raising rates wherever possible. I say this both because lower tax rates may have some modest positive effects on savings, investment, and work effort over the long run, and because even if they don't, low tax rates reduce tax sheltering and other unproductive allocations of people's time and money.

My fourth point: To the extent that we have exhausted the possibilities for broadening the tax base and are still left with deficits, the net effect of reducing tax rates is to produce larger deficits and lower economic growth. In particular, if the revenues saved by not reducing the top bracket rate or other rates were dedicated to reducing the deficit, the net effect on economic growth would, in my opinion, clearly be positive. Any reduction in personal savings or work effort resulting from higher personal tax rates would be more than offset by the impact of lower deficits on interest rates and investment.

My fifth point is that reducing the top rate to 35 percent is likely to be perceived as unfair. Income disparities have been widening in recent years and the distribution of income would be made still more unequal by the administration's current proposal.

For example, every middle-income family would have had almost $1,000 in additional income in 1984 if they had received the same share of the total income pie that they did back in 1970. As it is, they have been losing ground to the more affluent.

The tax cut of 1981 contributed to this growing inequality and the administration's proposed rate structure would further exacerbate the trend.

I want to make one other technical point here because I think it's an important one. The administration defines a distributionally neutral tax system as one in which the percentage reduction in taxes is the same for all income groups. But in a progressive tax system, even a tax cut that is distributionally neutral in this limited sense, will raise the after-tax income of the affluent more than the after-tax income of the not so affluent and, thus, contribute to growing income disparities.

To conclude, what I recommend is, first, further base broadening as the preferred means of raising revenues; second, an adjustment in tax rate at the end of this process which will simultaneously increase revenues to be applied to the deficit; and at a minimum preserve the existing distribution of income.

Thank you.

[Mrs. Sawhill's prepared statement follows:]

Prepared Statement of Isabel V. Sawhill

I appreciate the opportunity to present my views on the impact of tax incentives on economic growth and on the question of whether it is desirable to reduce the top marginal rate from 50 percent to 35 percent in light of the evidence on supply-side effects. Briefly, my conclusions are as follows:

1. The impact of tax incentives on economic growth has been greatly exaggerated by supply-side economists.
2. There is little evidence of a supply-side response in the data on savings, investment, and work effort for the period 1981-84.
3. Tax rate reductions might have modest positive effects on economic growth over the longer run. High tax rates also create incentives for people to engage in unproductive activities so as to minimize their taxes. For these reasons, we should raise revenues by broadening the tax base rather than by raising rates, wherever possible.
4. However, to the extent that no further base broadening is possible, and deficits still persist, the net effect of any rate reduction is to produce larger deficits and lower economic growth.
5. Finally, reducing the top rate to 35 percent is likely to be perceived as unfair. Income disparities have been widening in recent years and the distribution of income would be made still more unequal by the Administration's current tax proposal.

The 1980s have been a decade devoted to frequent changes in the tax law. The process began in 1981 with the Economic Recovery Tax Act which sharply reduced both individual and corporate income taxes. The major justification was the expectation that increased tax incentives would greatly

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The author is an economist with The Urban Institute. This testimony represents her personal views and not those of the Institute or its sponsors.

spur economic growth. To this end, the top personal rate has been reduced 28 percent (from 70 percent to 50 percent) and the after-tax cost of undertaking new investments has been reduced by about 3 percent.

More changes appear to be in the offing. The Administration proposes to reduce marginal rates at almost all income levels and the top personal rate another 30 percent (from 50 percent to 35 percent). Most estimates suggest the after-tax cost of new investment will be little affected by the President's proposals.[1]

While everyone likes low tax rates, the country is currently hard-pressed for revenues; what is to be gained by further reductions in tax rates? What have we learned since 1981 about the growth-producing effects of supply-side strategies? And, in the context of the current debate over tax reform, is a further reduction in the top rate the most appropriate and fairest way to encourage future growth? The rest of my testimony addresses these questions.

The Record to Date: Supply-side Economics in Practice[2]

The tax changes introduced in 1981 were, in part, a response to the disappointing economic performance of the 1970s--particularly the slowdown in productivity after 1973. While there were complaints about an inflation-induced rise in business tax burdens during the 1970s, effective tax rates on

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1. Although the proposed depreciation lives are longer than under current law, the basis is indexed for inflation so that under modest assumed inflation rates (e.g., 4 percent) and the usual discounting assumptions (4 percent) the cost of capital is not significantly different. Under higher inflation rates, the cost of capital is unambiguously lower under the President's proposal.

2. Much of the material in the next two sections is drawn from Charles F. Stone and Isabel V. Sawhill, Economic Policy in the Reagan Years, Washington, D.C.: The Urban Institute, 1985, Chapter 4: "Prospects for Long-Term Growth". Additional details and evidence will be found there. Also see Joseph J. Minarik, Making Tax Choices, Washington, D.C.: The Urban Institute, 1985.

capital did not increase over this period and thus could not have been a significant factor in slowing the growth of capital per worker, and thus productivity.[3] Nor is there evidence that rising personal tax rates had much of a negative effect on savings or labor force participation rates during this period. Both gross savings as a proportion of GNP and labor force participation rose during the 1970s. While these trends could be the result of other factors that worked to offset the negative impact of rising marginal tax rates, careful attempts to isolate the effects of taxes on savings and work effort suggest that any such effects are far more modest and uncertain than supply-side rhetoric would imply.

Looking at the record for 1981-84 against a benchmark of comparable periods in previous business cycles, it is hard to discern any supply-side response to the Reagan tax cuts in the data on personal saving, labor force growth, or business fixed investment, although there was an unusually large increase in business savings or cash flow (Chart 1). Several studies suggest that business fixed investment has been stronger during the recent recovery than one would have predicted based on past experience.[4] However, the composition of business spending has not been what one would have expected based on the changed structure of tax incentives.[5]

Another argument made by many tax cut proponents was that lower marginal

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3. Congressional Budget Office, "Revising the Corporate Income Tax," May 1985, p. 35.

4. This is not evident in Chart 1 but shows up in some macroeconomic model simulations. See Alan S. Blinder, "Reaganomics and Growth: The Message in the Models," in Charles R. Hulten and Isabel V. Sawhill, eds., The Legacy of Reaganomics: Prospects for Long-Term Growth, (Washington, D.C.: The Urban Institute Press, November 1984), and Michael Boskin, testimony before the Ways and Means Committee, June 11, 1985.

5. Barry Bosworth, "Taxes and Investment Recovery," Brookings Papers on Economic Activity, 1985:1.

rates would reduce incentives to engage in unproductive activities or invest in tax shelters. While this is true, and an important reason to keep tax rates low, distortions in the tax system were made worse by the 1981-82 actions and tax shelters have continued to grow. Pleas by the business community and other interest groups to maintain various preferences threaten to produce a similar outcome now.

If tax incentives played little role in the 1983-84 recovery, what did? Both fiscal and monetary policy became much more expansionary during 1982 and 1983, and it was this impetus to demand along with the economy's natural recuperative powers that fueled the recovery.

While the recent record is suggestive of what can and cannot be accomplished with tax incentives, it is cetainly not definitive. Supply-side incentives are not very effective during periods of high unemployment and unused capacity, and they may change behavior only gradually in any case. Thus, over a longer time period, it is possible that they could play a more important role.

The Longer-Run Potential

As part of our research on the impact of the Reagan Administration's policies on the economy, we have attempted to estimate the likely effects of tax and other policy changes on long-term economic growth. Because of the many uncertainties about the relationships involved, we estimated a range of possible effects (See Charts 2-4). Overall, we concluded that under optimistic assumptions, the Administration's policies might increase the growth rate of real GNP by four tenths of a percentage point per year over the coming decade (for example, from 3.0 to 3.4 percent). Under more pessimistic assumptions, these same policies could reduce the growth rate over this period by a roughly comparable amount (for example, from 3.0 to 2.7 percent). One of

the assumptions in our optimistic scenario was early and significant action on the deficit. Since this has not occurred, I would now have to give much greater weight to our pessimistic set of projections. In short, although new tax incentives to encourage saving, investment, and work effort are all predicted to have some positive effects (though the case of saving is questionable), in the absence of firm action on the deficit, these positive effects are quickly offset by the negative impact of increased federal borrowing on interest rates and investment.

Should We Reduce The Top Rate Further?

The scholarly evidence from which our long-term projections were derived suggests some modest positive effects from lowering personal tax rates--especially on labor force participation or hours worked. But the effects are small and since they are not clearly discernible in the data for 1981-84, one can be a skeptic and say they are a figment of economists' models (or their imaginations) or one can be a believer and say that our research tools haven't been precise enough to detect them in the recent period or that we haven't given them sufficient time to work.

High tax rates also create incentives for people to engage in unproductive activities and to shelter their income from taxes. For these reasons, we should raise revenues by broadening the tax base rather than by raising rates, whenever possible.

However, given the lack of clear and compelling evidence that earlier tax cuts have had the desired impacts on economic growth, I would argue that we should not now embark on a new experiment to reduce the top marginal rate by another 30 percent. I suspect (and the scholarly evidence tends to confirm) that whatever the economic effects of reducing the top rate from 90 percent to 70 percent (in 1969) or from 70 to 50 percent (in 1981), the benefits of

moving from 50 percent to 35 percent are likely to be less. Moreover, these uncertain economic benefits should be compared with the benefits to be derived from other possible uses of an equivalent amount of foregone revenue. In particular, if the revenue saved by not reducing the top bracket rate were dedicated to reducing the deficit, the net effect on economic growth would clearly be positive.[6] Any reduction in personal saving or work effort would be more than offset by the impact of lower deficits on interest rates and investment.[7]

In the final analysis, however, the case for not reducing the top rate or for adding a fourth bracket rate of, say, 40 or 45 percent rests primarily on concerns about fairness. Such concerns have grown for a number of reasons. First, the distribution of income has become increasingly less equal in recent years. If the middle class (middle quintile in the income distribution) had had the same share of total personal income in 1984 that they had in 1970, each middle-income family would have been $932 richer, on average, in 1984. As it is, they have been losing ground to the more affluent, particularly to the richest one-fifth of all families. Second, the 1981 tax cut contributed to this trend; it increased the 1984 after-tax income of the affluent (top one-fifth) by 5.9 percent but the after-tax income of the middle class (middle one-fifth) by only 2.8 percent.[8] Third, the budget cuts already enacted as

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6. The effect would be very small, however, since the revenue gains associated with increasing rates at the top of the income distribution are quite modest.

7. See Charles F. Stone, "Tax Cuts, Deficits, and Long Term Growth," Changing Domestic Priorities Discussion Paper (Washington, D.C.: The Urban Institute, August 1985).

8. See Marilyn Moon and Isabel V. Sawhill, "Family Incomes: Gainers and Losers," in John L. Palmer and Isabel V. Sawhill, eds., The Reagan Record: An Assessment of America's Changing Domestic Priorities, (Cambridge, MA: Ballinger Publishing Company, 1984).

well as those contained in this year's budget resolution tend to exacerbate these disparities.[9] Finally, the Joint Committee on Taxation estimates that the Administration's tax proposal will increase the after-tax income of the broad middle class by about 1 percent. In contrast, those with incomes between $75,000 and $200,000 would experience increases of around 2 percent, and those with incomes of $200,000 and above would experience an increase of 6 percent.[10] For those of us who believe that current income disparities are large enough, such evidence points to a compelling need to make some adjustments in the Administration's proposals.

I would recommend further base broadening (e.g., the inclusion of indexed capital gains, the elimination of preferences for specific industries, the elimination of state and local tax deductions). Some consideration should also be given to reducing the generosity of the proposed personal exemptions (with appropriate adjustments to protect the poor). When all of this was done, I would adjust tax rates to simultaneously increase revenues and preserve, at a minimum, the existing distribution of income.

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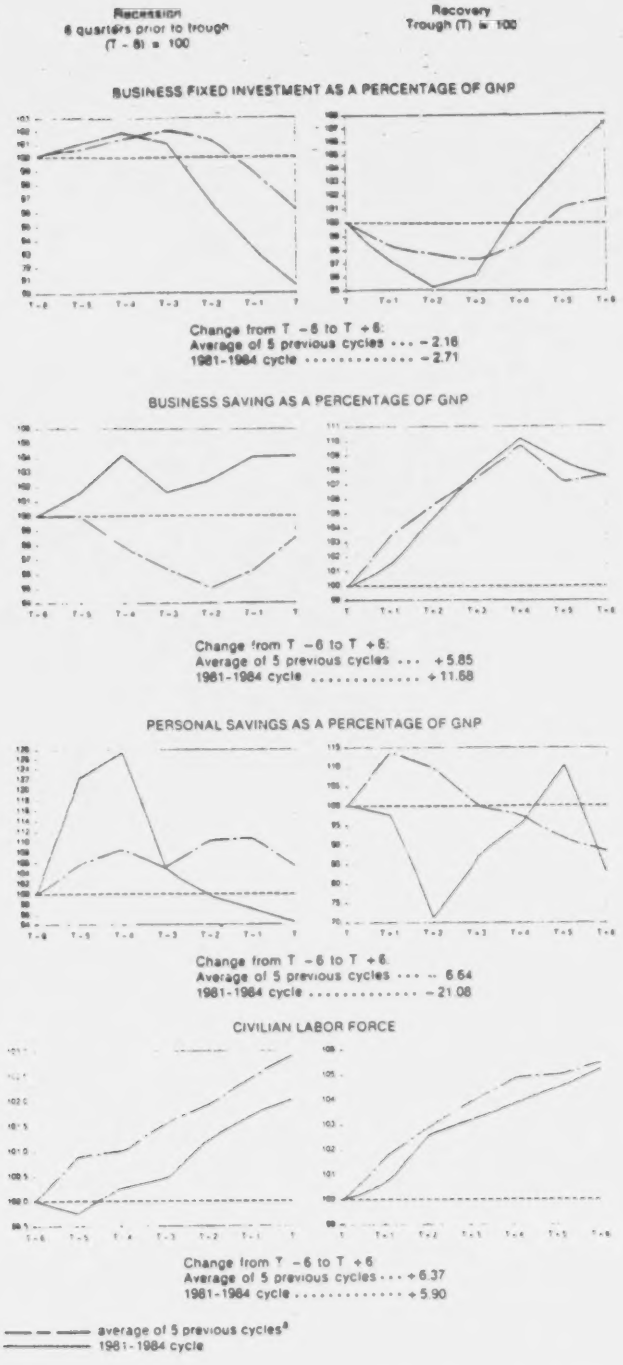
9. See Gregory B. Mills and Charles F. Stone, "Distributional Effects of 1986 Budget," Changing Domestic Priorities Discussion Paper (Washington, D.C.: The Urban Institute, forthcoming).

10. Joint Committee on Taxation, Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues, August 12, 1985, p. 39.

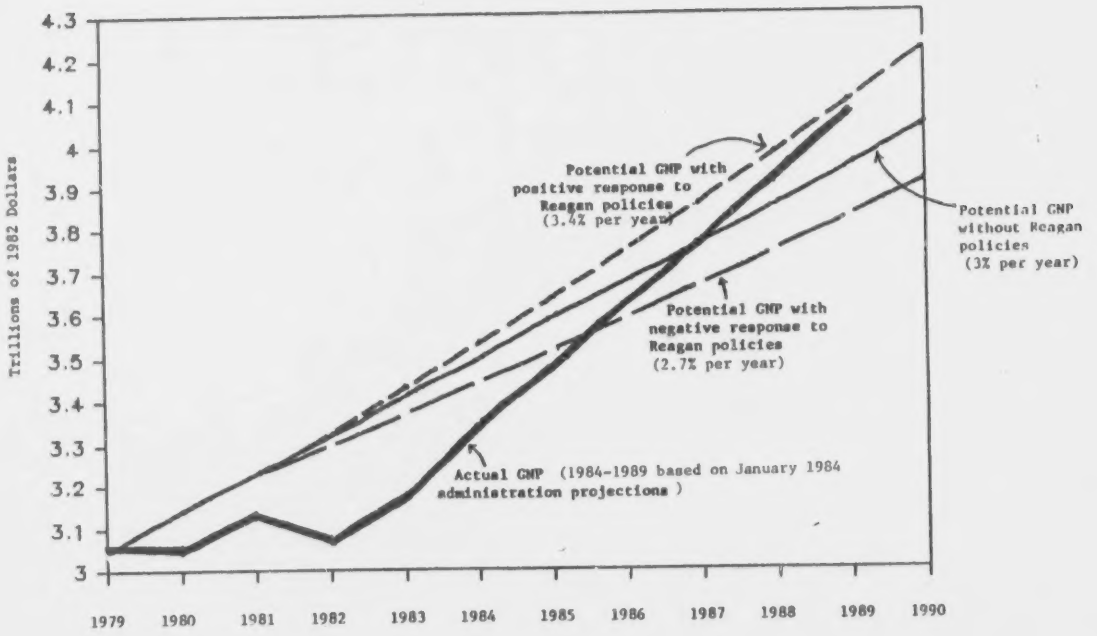
CHART 1


Recession
6 quarters prior to trough
(T - 6) = 100
Recovery
Trough (T) = 100
BUSINESS FIXED INVESTMENT AS A PERCENTAGE OF GNP
Change from T −6 to T +6:
Average of 5 previous cycles ... −2.16
1981-1984 cycle ..... −2.71
BUSINESS SAVING AS A PERCENTAGE OF GNP
Change from T −6 to T +6:
Average of 5 previous cycles ... +5.85
1981-1984 cycle ..... +11.58
PERSONAL SAVINGS AS A PERCENTAGE OF GNP
Change from T −6 to T +6:
Average of 5 previous cycles ... −6.64
1981-1984 cycle ..... −21.08
CIVILIAN LABOR FORCE
Change from T −6 to T +6:
Average of 5 previous cycles ... +6.37
1981-1984 cycle ..... +5.90
average of 5 previous cycles[a]
1981-1984 cycle

SOURCE: Charles F. Stone and Isabel V. Sawhill, Economic Policy in the Reagan Years (Washington, D.C.: The Urban Institute Press, 1984).

Chart 2

ACTUAL AND POTENTIAL GNP, 1979-1990



SOURCE: Isabel V. Sawhill and Charles F. Stone, "The Economy," in The Reagan Record, figure 3.6, p. 103.

Chart 3

OVERVIEW OF ESTIMATED IMPACTS OF REAGAN POLICIES ON ECONOMIC GROWTH

	Estimated Change in the Annual Growth Rate of Real GNP during the 1990's		
	Lower Bound	Upper Bound	
Capital formation	-0.28	+0.12	See Chart 4 for details
Labor supply	+0.06	+0.18	
Regulation	0	+0.10	
Education and training	-0.04	0	
R and D	-0.08	+0.04	
TOTAL	-0.34	+0.44	(cf. Chart 2)

SOURCE: Isabel V. Sawhill and Charles F. Stone, "The Economy," in The Reagan Record, table 3.7, p. 102.

Chart 4

ESTIMATED IMPACT OF REAGAN POLICIES ON CAPITAL FORMATION AND ECONOMIC GROWTH

	Estimated Change in the Annual Growth Rate of Real GNP During the 1980s	
	Lower Bound	Upper Bound
Capital Formation	-0.28	+0.12
Economic Slack	-0.07	-0.03
Tax Incentives for Private Investment	+0.06	+0.12
Public Investment	-0.09	+0.03
Tax Incentives for Private Saving	0	+0.09
Deficits	-0.18	-0.09

SOURCE: Isabel V. Sawhill and Charles F. Stone, "The Economy," in The Reagan Record, pp. 96-99.

Representative OBEY. Thank you very much, both of you.

I have a few questions to try to bring out for the record the points I would like clarified by today's hearing.

The President's plan would cut tax expenditures, reduce marginal tax rates, including cutting the top marginal rate from 50 to 35 percent, and make no reduction in the deficit or actually perhaps enlarge it. An alternative would cut tax expenditures and apply the revenue to deficit reduction, rather than cutting those marginal rates. Which would be a better economic policy?

Mrs. SAWHILL. The second.

Mr. BOSWORTH. I would agree.

Representative OBEY. I agree with that, too, but there are some people who say this:

Sure, we have a crunch in the manufacturing sector right now, and, sure, we have a temporary trade deficit, but what you have to understand is that long term you folks who are worried about the effects of the deficit on future generations are really worrying more about a theoretical problem than a practical problem.

They will say:

Isn't it possible that the wringing out of the manufacturing sector today is simply an elimination of those firms that are least able to compete internationally? After we have had that shaking out, those sectors will be in a leaner position than before, and they will be better able to compete. That, coupled with the huge amount of research which we're doing, will mean that in the end we will be able to deal with the

trade deficit problem because we will have strengthened our economy. So you shouldn't worry about trade deficits, and you shouldn't worry about our becoming a debtor nation. You ought to worry simply about whether or not the economy is humming along today.

What's your response to that?

Mrs. SAWHILL. Well, I think that Mr. Bosworth has already addressed that issue quite effectively. This is not just a matter of shaking out inefficient industries. With the value of the dollar being what it is right now, we can't compete on any front very well.

Representative OBEY. I understand that, and I don't disagree with you, but there are people who say:

Look, that isn't going to be permanent. We have a slow decline of the dollar right now. You guys are worrying about something which is a short-term phenomenon. The system will right itself eventually without drastic action on budget deficit reduction or anything else. So let's not worry about this theoretical debt we're going to leave to our grandchildren because we'll be generating enough economic growth down the line to take care of the problem.

Mr. BOSWORTH. I think there are two ways in which that argument is wrong in applying it to the United States. One is that there's nothing temporary about what's happened to the United States in terms of the competitive position. As I tried to illustrate earlier with the savings and investment table that I handed out, given our national savings rate, what people forget is we have to borrow overseas to finance any investment here in the United States. Our national savings rate is down to 3 percent of GNP. If you want to invest in the United States, the only people who have the resources to do it are foreigners.

That suggests that the United States engage in a program where we are going to borrow every year overseas something between $100 and $150 billion just as long as our national savings rate continues at this level.

It is a mistake to believe that somehow the exchange rate is going to come back down again. It is not going to come back down again until it's no longer necessary for the United States to borrow overseas. And I don't see any likelihood at all that that's going to change.

We've just been through another round of extensive discussions on the budget and what has emerged is the same budget deficit that we were projecting before. There's no evidence that private savings rates are going to come back up. So the only thing the United States has a hope to look for in the future, I think there is one reason why we're not going to have to borrow overseas quite as much any more and that is that our own domestic investment is going to start to go down, and that's what's happening already. Investment growth is beginning to fall short of the growth in output.

So, first, this isn't just a temporary fluke. This is a fundamental shift in savings and investment in the United States that necessitates overseas borrowing on a long-term basis.

The second problem with it is, there's a tendency for people to think that a rise in the exchange rate is going to put the most pressure on your weakest industries and drive them out and you will come out of this leaner and meaner. That's not the way the process works.

What happens first of all is an exchange rate increase puts pressure on two types of industries—your import-competing industries. Those are usually your worst, your most inefficient, the ones that are kind of declining over time anyway. What happens in that case? They come marching down here to Washington and demand trade protection and you usually give it to them. So they end up being subsidized by Government and continuing to operate.

On the other hand, your leading industries, your most technologically innovative, are on the export side of your economy. Most economies will export goods from those industries that are most dynamic and most innovative. There's almost nothing you can do to help your export industries in the face of the fact they can't sell overseas because their prices are too high.

You see it here in the United States. The big declines that the United States has experienced in its competitive position in world markets is in the capital goods industry, not in steel or textiles or the ones that get a lot of public attention. We used to have an extremely large trade surplus in the export of capital equipment from the United States. We are now to the tune of about $30 billion a year a net importer of capital equipment.

Second, just look at what has happened to the computer industry and try to tell this story to people out in Silicon Valley that it's making them leaner and meaner. They simply can't meet the Japanese competition for the production of computer parts. We will continue to have engineers coming out of American universities working on the design of new computers, but once we figure out how to make them we're going to produce them overseas. And even well-known brands like IBM and others, if you take those computers apart, you will find the parts are made overseas. And that trend is going to continue.

Another company, if you want to get specific, that I think shows the problems that we are facing most dramatically, is a company in the Midwest, and that was Caterpillar Tractor. Caterpillar Tractor throughout the 1970's was an exporter, an enormous exporter, the United States third largest export corporation in the production of construction equipment. We were generally regarded that with that company that we were the world's lowest cost source of production for those types of goods. Caterpillar Tractor in fact paid UAW wages and still had the world's most modern plants and production facilities.

In the 1980–82 recession, with the rise in the dollar and the collapse of the U.S. economy, that company was forced into an enormously high-debt position. It laid off thousands of workers, abandoned most of its research and development programs, and ceased to modernize its plants. Caterpillar Tractor was for a period of time on the verge of financial collapse.

It has in the last year come back somewhat. It's interesting how it came back. All the growth is in its overseas production facilities. In other words, Caterpillar Tractor represents a trend that's just inevitable for American corporations. They're going to have to move their production facilities overseas because the cost of production here in the United States is too high.

Instead, what we're getting is those industries that sell goods and services that can't be moved in international trade, they grow very

rapidly because, boy, American consumers are very anxious to spend and so is the Government and they can sell a lot to both. So industries that don't get involved in trade, either on the import-competing side or the export side, are growing rapidly. But there is no reason to think that that's a good trend for the United States.

If you look at our technological base, our work force, and our education facilities, the United States should be producing computers today. It is an area of enormous advantage for us. But that is not what the market is telling us. The market is telling us to move out of these areas of competition because they are in the area of tradable goods and we're just seeing a very rapid collapse of the whole tradable goods sector of the U.S. economy.

A final point to be made on that, this is not easily reversible, even if the dollar should come back down again. The history has been that when companies fall behind their competitors and they take on a lot of debt and they have to abandon their research and development, it is almost impossible to catch back up again. There are very few examples of major corporations that have ever turned around and come back to lead a market once they fell behind. It is enormously difficult to catch back up again and that's going to place a burden on American firms even if we should bring down the budget deficit and get the dollar back to reasonable levels.

I think we are now faced with a situation where in fact the exchange rate will have to be substantially lower than it would have been in the absence of this program in order to enable American industry to compete in world markets. We've let people get a foot in the door in industries that we used to dominate and they are not going to back off in any kind of easy pattern in future years.

Representative OBEY. Let me ask a question about the trade war—not the one that's going on internationally, but the one that's going on on Capitol Hill.

As you know, everybody came back from the August break in their districts, and the No. 1 topic is trade—do something; we don't know what, but do something. We hear one thing from the grassroots. We hear quite another thing from many experts in the field of economics.

We see a Congress moving toward passage of a number of trade bills which will be restrictive in nature. We see the President praised for resisting that. And yet the implication of what you said is that the policies that the President and Congress have followed, certainly in terms of the budget, are causing the pressures which you feel out in the countryside.

And you're saying that a substantial part of our trade problem is really made in America, not abroad.

Do you have any specific objection to the manner in which the major trade bill which is being discussed right now deals with the issue of, say, Japan, by getting to the bottom line in terms of the trade deficit with that country?

The central item of the Bentsen-Rostenkowski-Gephardt bill is the requirement that the President slap on a surcharge if the trade deficit with Japan does not reach a certain level.

Do you have a specific comment on that technique? How would you deal with the Japanese situation?

Mr. BOSWORTH. Well, I think that Japan does have a problem. It is in this respect simply the opposite of the problem faced by the United States. They are a country with an extremely high savings rate. In fact, they have actually reduced over recent years the size of their budget deficit so their national savings has tended to go up a little bit.

At the same time, while they are growing rapidly, they are not growing as rapidly as they used to and, therefore, their private investment shares have tended to decline a little bit. They are a savings surplus economy. They are generating savings in excess of their domestic investment equal to 3 percent of their GNP.

We're generating savings short of our investment by 3 percent of GNP. We borrow. They invest. The fundamental problem here I think is imbalances between the two countries in savings and investment. It's hard to criticize the Japanese because they want to save and I think that's the basic difficulty with these trade bills.

We dissave and then because we can't deal with our own budget deficit we'd like to go out and blame foreigners and there's nothing new historically about that pattern. There's frustration when you can't deal with it domestically and it's very popular to blame foreigners.

I think that there is a problem for Japan, that it can't expect year after year to run a trade surplus with the rest of the world of this magnitude. It puts too many strains on world capital markets and on trade balances. After all, despite the fact you think it is good to import more than you export and you can consume, the real purpose of trade today in the eyes of most countries is to promote employment. And the notion that Japan tries to keep its economy going by exporting goods into the world market causes obvious strains.

So I think there are problems on both sides here to be dealt with. But it is not fundamentally a difficulty of trade restrictions and, therefore, I think that the proposal here in the United States to attack it that way will simply be ineffective.

I would expect to see our trade deficit with Japan decline a little bit and our trade deficit with somebody else will go up just to offset it. We'll just shift the deficit around the world economy a little bit but we won't deal with the fundamental imbalances.

So I think largely that that bill is futile. In fact, most economists looking at it simply in terms of economic effects, not taking any psychological account of how investors might react—but from a purely economic effect, putting on a tariff would drive your exchange rate up, not down, because now the imported goods cost more and you have to change the exchange rate to make them cheap again so you can afford to buy them.

I'm not saying that that would be the effect because I think there is a psychological effect on international investors. If we start slapping on trade restrictions, they're going to conclude we're nutty and this is not a very good place to invest any more because it looks like our policies are out of control and you might see capital move out and the exchange rate come down.

But in my mind, the biggest problem with this bill is that it simply doesn't address the fundamental difficulty. It isn't going to reduce the U.S. trade deficit. It's going to get Japan mad at us and

we're going to bicker back and forth. I suspect that what they'll do is they will put a restriction on their exports to the United States and export more elsewhere and then other countries will export more to the United States and we'll shift it around.

Representative OBEY. So you think that what Congress ought to keep in mind is that you cannot deal with the trade issue effectively unless you cut our budget deficit.

Mr. BOSWORTH. That's right.

Representative OBEY. You mentioned the Japanese savings rate. Some people in the field say, "Well, we don't have very good ways of measuring savings, so this number that you're pointing to may not be very indicative of what's really happening to savings." We don't treat an investment in housing as saving. They say that the savings rate may be low because the stock market has been going up, at least until the last few months. They say that you need to take into account factors besides flows of current income.

What's your response to that? How good is this measure? Are we counting the Japanese savings rate the same way that we count ours?

Mr. BOSWORTH. That's an issue that has been raised, particularly back in the 1970's. We looked around internationally at these enormous differences in savings rates among countries and one popular hypothesis that was developed was, well, maybe it's just because each country measures it differently. So there was, by the Organization of Economic Cooperation and Development, the OECD, which is a joint group of all the industrial countries, a study about 3 or 4 years ago to examine this issue. And they went back and computed everybody's national savings rate and private savings rate on the same basis.

There are differences in how we classify some types of expenditures. When you put all these together, the influence on savings rates is absolutely trivial. You cannot dismiss the fact that the United States is a low-saving country compared to other countries by an attempt to question the data or say somehow there are differences in classification. There are, but they are extremely small in terms of their quantitative impact on the saving and investment data.

Clearly, Japan both invests and saves at a rate nearly 50 percent higher than the United States.

Representative OBEY. What about the argument of Paul Craig Roberts and others that we haven't had enough time to test the supply-side theory, to determine whether tax cuts will in fact eventually increase savings rates?

Mr. BOSWORTH. Well, you can always say give it more time, give it more time. I think in terms of people adjusting their savings behavior, the awareness of the high rates of return, 4 to 5 years is an incredibly long lag in economic behavior.

I think, on the other hand, there is an argument that could be made that in the very long run another generation, if you want to wait that long, there could be a bigger effect. And I think the reason for it is fairly simple. All those people who had accumulated some savings before 1981, what do they find? Yes, it pays to save a little bit more, but the money that I had already saved is earning so much more money than I anticipated I'm a lot richer than I ex-

pected to be; therefore, I can afford to increase my consumption today.

We always have this problem that a change in the rate of return puts an incentive for new saving, but because it makes the old saving earn such a higher income stream, it actually can be perverse in encouraging consumption rather than discouraging it.

Now if you are willing to wait until all those people who had accumulated some wealth had died off, you may begin to see for 20-year-olds that over their lifetime, for example, they will save at a much higher rate. But even in this area it would appear that the effects are very small. The basic problem is that most individuals save with a specific purpose in mind and the major one is retirement. They want a certain level of retirement income. When you raise the rate of return, I actually don't have to accumulate as much wealth in order to achieve that income flow. At the same time, it does make it a little more attractive to do it.

The two effects tend to offset each other and the evidence both here in the United States and in other countries is it's very difficult to influence savings rates by variations in the rate of return on it. Other countries have higher rates but, just like ours, they tend to be very stable over time, very difficult to modify.

The one country I think that stands out that's the most interesting case to investigate—we don't have a good answer for it yet—is Canada. Canada has lots of other difficulties but one of the positive things that's happened in Canada is they have had a sharp increase in their private savings rate. That's the only country I know of that has had a major change in savings behavior over the last couple of decades.

I think the lesson you draw out of this—you can wait if you want to, but the evidence is getting increasingly strong that simply nothing of any dramatic magnitude is going to happen. I think the sign of the effect is right, savings is tended to be increased. But as mentioned by Mrs. Sawhill, the biggest problem is the effect is exaggerated.

Mrs. SAWHILL. If I could just add to that, I think the issue is not whether there might be some positive effects over the long run. I think it's possible that there could be.

The question is, if they're as small as every bit of evidence that we have suggests, then if the choice is between taking a dollar and using it to reduce let's say marginal tax rates or provide other incentives for savings and using that same dollar to reduce the deficit, a dollar reduction in the deficit increases national savings by a dollar or close to a dollar. A dollar devoted to provide tax incentives for savings, even if it increases savings, is going to increase it by far less than a dollar. There is no one that claims otherwise.

Representative OBEY. Mrs. Sawhill, in your prepared statement you indicate that if the middle class had the same share of total personal income in 1984 that they had in 1970, each middle-income family would have been $932 richer.

What income bracket are you talking about there?

Mrs. SAWHILL. This would be the middle quintile in the income distribution which is people with an average income of about $25,000 a year.[1]

Representative OBEY. Do you know what the range is?

Mrs. SAWHILL. It's probably about $20,000 to $30,000, but I would have to double check that.[2]

Representative OBEY. You both mentioned IRA's. I've felt since the day they were instituted that they're a national joke. My wife and I certainly take advantage of them, but it would be hard to demonstrate that we have increased our personal savings because of using an IRA.

What would we do with IRA's? Should we abolish the tax deductibility? Should we treat other savings differently? Should we encourage savings or should we simply focus on reducing the deficit?

Mrs. SAWHILL. Well, I think we keep coming back to that theme, that reducing deficits is the most important thing that you can do. I think that it's possible that once people have reallocated their existing savings into IRA's that one might begin to get some small positive effects there.

Another thing I think we have to worry about is the extent to which we have tended to subsidize borrowing for consumer goods in this country.

Mr. BOSWORTH. I would only add to that that I think the IRA's have been ineffective in part because the most disappointing thing about them is that they are not being taken by moderate income individuals. If you look at the tax returns, it just is very heavily dominated by people in very high income brackets who almost by definition have a lot of existing wealth that they can reallocate to those accounts at the rate of $2,000 a year probably for another 10 to 15 years before they'll run out of wealth and there's any potential impact.

I think, instead, what has worked much better in the United States to increase this type of saving—I think there's a legitimate social reason—we would like to see people save for retirement so that you don't get into social problems of people who are retired not having adequte income. Social Security is designed to provide a minimum but we do under the tax law all along allow a tax deduction for employer contributions to pension funds. We have always had that. And the benefit of the tax deduction for those types of plans is that by law they have to be extended to all employees. We don't get this self-selection process if the lower income workers decide not to do it and the upper income workers do. We have a uniform tax treatment that says it's deductible for tax purposes if the employer provides the program for every employee.

So I think if the objective of Government is to encourage people to provide for retirement, we have a mechanism that has proved to work extremely well, and that is employer deductibility of private pension costs. If you wanted to make that increase private rates and have a more dramatic effect on national saving and wanted to use that tool, then what you would do is require employers to fund the program at a higher rate.

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[1] The median income was $26,433 in 1984.

[2] The range was $21,700 to $31,500 in 1984.

For example, a defined contribution plan as opposed to the more standard types of defined benefit program in the United States, a defined contribution plan says the employer provides 10 percent of your wages into a pension fund and he has to come up with it the day you earn the money. He puts it in a completely separate pension fund and that money is invested and earns a rate of return for your retirement. It's fully funded, in other words. It is a dollar of national saving.

When firms promise you a retirement benefit under a defined benefit plan, they don't fund all those obligations. They just rely that in the future they will continue to be in business and earn profits to pay it off.

Now if you force people to fund retirement programs on the day the liability originates, you do get an increase in national saving. If you want to see an example of this, take a look at the national income accounts about pension fund surpluses of State and local governments for their employees. That fund, net growth in it has been expanding at just a phenomenal pace over the last decade. It's now added a full percentage point to the national savings rate just from that single type of pension program, State, and local programs for their employees. And the reason is, that State governments have become increasingly nervous about the failure to fund those pension programs back in the 1940's and 1950's and all through the last two decades they've been rapidly raising the funding rate that applies to them.

So there is a mechanism other than IRA's to serve both our goals of increasing the national savings rate and encouraging people to provide for their own retirement, rather than using a program that turns out to be very discriminatory by income class. After all, if you're in a 20-percent tax bracket, an IRA is really not very advantageous. But if you're in a 50 percent tax bracket, it's one of the greatest gimmicks to come down the road in a long time. It costs you almost nothing. It costs you 50 cents on the dollar to put money in it.

Representative OBEY. Let me ask one question on labor supply. As you know, in 1981 the President said that his tax program was necessary to encourage work incentives. Parenthetically, I notice that Mr. Laffer has indicated that as far as the welfare system is concerned, we have reduced work incentives over the last 4 years, rather than increasing them. But on the overall question of labor supply, the percentage of the adult population looking for work rose more rapidly in the 1977–80 period than in the 1981–84 period.

Does that indicate that work incentives have not been stimulated by the 1981 tax cuts? Does it indicate that work incentives were not inadequate in 1981? Perhaps I should parenthetically ask, as two economists who are much more aware of the intricacies of the Tax Code than the average citizen in this country, do you feel that you're working harder than you were in 1981?

Mrs. SAWHILL. I think that one has to be a little bit careful about comparing the late 1970's to the early 1980's because of the fact that the baby boom has now completed its entry into the labor force and the growth of the labor force is slowing down for that reason alone and that tends to dominate the figures.

However, I think it is the case that all through the 1970's the labor force was growing very rapidly in spite of the fact that marginal tax rates for most families were increasing at the same time, so there doesn't seem to be any strong evidence of a relationship between the two.

I do think that the impact of tax rates on work effort is probably greater than the impact on savings. That's what all the studies that we have suggest. But again, the effects are rather small, in part, I think, for the reason you just suggested, which is that most of us don't have that much flexibility to vary our hours of work.

There are also some other provisions in the Tax Code that probably have greater effects on work effort than do marginal tax rates. I think here particularly of the second earner deduction which I think encourages particularly married women to work more and probably has far greater impact on work effort than do tax rates themselves, and yet the administration has proposed to do away with that.

Representative OBEY. One last question. Mr. Bosworth, in your prepared statement you say:

> Over the postwar period, the only increase in taxes has been in that on labor income—effective tax rates have fallen on capital income. We should be more concerned about the disincentive effects of higher wage taxes on work effort rather than focusing so heavily on capital income taxes at the top of the income distribution.

Can I conclude from that and everything else you've said that if Congress wants to encourage greater work effort we ought to focus not on efforts to increase the return on capital investment, but on efforts to make the Tax Code more rational and less discouraging of individual effort on the part of workers? Also, do you believe that Tax Code changes ought to be our primary concern, or should it be simply reducing the budget deficit?

Mr. BOSWORTH. I guess the caution that I think that gets lost in all this discussion about groups coming in and saying, "Give me a tax advantage because I'll do good things with it or that private savings rates will be increased," what I think the public and the Congress tend to forget in these discussions is that a decision not to tax someone's income is a decision to therefore raise the tax rate on everybody else because somebody has to pay for that tax benefit.

What has been happening in the United States, despite all the talk of the last few years about savings rate and capital income taxation discouraging savings and investment, if you look at the Federal tax system, the only taxes that are edging up in the United States as a share of income are employment taxes and we are putting heavier and heavier taxes on people who want to come into the work force. And I think you have to be, yes, worried about savings incentives and wherever possible, as Isabel Sawhill mentioned, I think you aim for a tax system that is as broad as possible with the lowest rates. You also have to worry about the effect of the extra burden that's being placed on labor when you exclude so much of capital income from taxation.

There is, for example, a recent study that shows that over two-thirds of all capital income in the United States is now exempt from the personal income tax system and, yes, the income that is reported gets taxed at a fairly high rate, but the average tax rate

on capital income under the personal tax system is now down to 10 percent in the United States. It is lower than it is for wages.

I think that this whole thing about trying to do good things with the tax system has become so completely out of control as one special provision has piled on top of another that as economists it's time we tell you that maybe we know at the margin what the effect of one proposal is, when it interacts with all the others that are already in the tax law, we have not the foggiest notion whether this tax system is encouraging or discouraging anything because it has just become too complicated to tell.

We can give you tax rates on different types of financial assets that vary from huge negative numbers to very high positive numbers, depending completely on the assumptions you make about who did it, how it was financed, and so forth. The tax system has become a joke. And yet economists probably know more about it than the average American. To assume that the average American can figure that whole complex system out and allocate his work and savings effort in the directions that the Congress thinks those bills are going, I think has become ridiculous.

Therefore, I would urge the Congress to go back to a much simpler notion of a tax system and focus on the primary obligation of taxation which is to raise money to pay for public services and to emphasize again, there really is no free lunch. You have to pay for what you get and that's what's completely gotten lost sight of in the whole discussion of taxes, as though there's no connection any more at all between Government expenditures and Government taxes. The whole tax discussion is just who's going to get a tax break.

Representative OBEY. What amazes me about the entire discussion of tax reform around here is that, at least up until the last 3 weeks, it has not been about whether you should have a revenue neutral bill or a bill which reduces the deficit. The choice has been between a revenue neutral bill and a bill which loses revenue.

I would also observe, while agreeing with you that deficit reduction ought to be the No. 1 priority, that when I came here in 1969 I had a typical newcomer's enthusiasm about what a little tax reform would do for the country. Like every other politician, I was in love with the title "tax reform." But the longer I've seen the system work, the more I have come to believe that whenever tax reform is mentioned, if anybody makes $50,000 or less they ought to simply put both hands on their wallet and hang on for dear life, because it usually means something quite different than middle-class people think it's going to mean when the debate starts. I would like to think this cycle will be different, but having seen round 1 of the show, I have some doubts about what we're going to see in round 2.

I thank you both for coming here this morning.

The committee is adjourned.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]

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